

**Accounting for Pensions
By State and Local Governmental Employers**

**White Paper
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INDEX

Background	1
Statement 27	1
Parameters	2
Initial NPO Calculation	3
Required Notes to the Financial Statements	3
Required Supplementary Information	4
Defined Contribution Plans	4
Statement 26	4
Notes to Financial Statements	5
Statement 25	5
Notes to Financial Statements	5
Sample	6
Footnote	6
Three-Year Trend Information	7
Required Supplementary Information	7

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BACKGROUND

The Governmental Accounting Standards Board (GASB) issued Statement 27 (November 1994) to establish measurement, recognition, and display standards for pension expenditures/expense and related liabilities, assets, note disclosures, and, if applicable, required supplementary information in the financial reports of state and local governmental employers. Reporting requirements for pension trust funds of employers are included in two related statements: Statement 25 (Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans) and Statement 26 (Financial Reporting for Postemployment Healthcare Plans Administered by Defined Benefit Pension Plans).

Statement 27 is effective for periods beginning after June 15, 1997. Statements 25 and 26 are effective for periods beginning after June 15, 1996. Both Statements 25 and 26 should be implemented in the same fiscal year.

Statement 27 affects all governmental employers that are members of the California Public Employees Retirement System, or any other similar retirement system. Because GASB 25 and 26 address plan financial reporting, they are applicable only to governmental entities that administer their own defined benefit pension and/or defined contribution plans and related postemployment healthcare plans. As a result, most agencies participating in California PERS are not affected by Statements 25 and 26. Accordingly, this document primarily covers Statement 27, although Statements 25 and 26 will be discussed.

This document, prepared by CCMA, is meant to assist California public agencies and their auditors in the accounting and reporting of pension plans.

Statement 27

Statement 27 (and Statement 25) supersedes all previous guidance, including Statement 5. This means that once an employer adopts Statement 27, the previously required standard pension disclosure, PBO, is no longer required. Instead, sponsors will disclose information consistent with their funding policy. Employers that participate in single-employer or agent multiple-employer¹ defined benefit pension plans will report an annual pension cost (APC) equal to the annual required contribution (ARC) plus an adjustment for the cumulative difference between the APC and the employer's actual plan contribution. The cumulative difference is called the Net Pension Obligation (NPO)².

The APC equals the ARC:

- plus one year's interest on the NPO,
- minus an amortization of past contribution deficiencies (or plus an amortization of past excess contributions) already included in the ARC - the amortization equals the beginning of year NPO divided by a present value factor (provided by the actuary).

¹ Cal-PERS, except for the School pool, is an agent multiple -employer defined benefit pension plan. The School pool is a cost sharing multi-employer defined benefit pension plan.

² Unless otherwise mentioned, NPO also refers to Net Pension Asset.

Accounting For Pensions
By State And Local Governmental Employers
Continued

The GASB has made it clear that, prospectively, the plan's actuary should provide plan sponsors a single ARC and that contributions different from the ARC generate an NPO.

The following example illustrates the NPO calculation:

FYE Ending	ARC	APC	Contr.	NPO		Amort. Factor	Interest Rate
				BOY	EOY		
1987	10,000	10,000	8,000	0	2,000	-	8.00%
1988	10,200	10,160 ³	10,200	2,000	1,960	10.00	8.00%
1989	10,200	10,157 ⁴	10,200	1,960	1,917	9.80	8.00%

The amortization factor and interest rate should be provided by the plan's actuary (Cal-PERS) each year.

Parameters (also included in Statement 25)

The ARC must be calculated within certain parameters. Cal-PERS' actuarial methods and assumptions are consistent with these parameters prospectively, except, perhaps as noted in footnote 7 below. The most notable parameters are:

- Valuations:
 - must be prepared at least every two years (annual requirement if significant changes from prior valuation);
 - Statement 25 - required supplementary information prepared using valuation within 12 months of beginning of plan year⁵.
 - Statement 27 - current year's ARC calculated within 24 months of beginning of fiscal year^{6,7};
- Actuarial methods and assumptions used in sponsor financial reporting should be the same as used in plans' funding requirements.
- The ARC calculation should include all benefits specified in (1) plan and (2) statutory or contractual agreement(s), in force at valuation date.
- Economic assumptions:
 - investment return assumption (interest rate) should be based on the plan's estimated long-term investment yield;

³ $APC_{1988} = ARC + (NPO @ \text{Beginning of Year} * \text{Interest Rate}) - (NPO @ \text{Beginning of Year} / \text{Amort. Factor}) = 10,200 + (2,000 * .08) - (2,000 / 10) = 10,200 + 160 - 200$

⁴ $APC_{1989} = ARC + (NPO @ \text{Beginning of Year} * \text{Interest Rate}) - (NPO @ \text{Beginning of Year} / \text{Amort. Factor}) = 10,200 + (1,960 * .08) - (1,960 / 9.8) = 10,200 + 157 - 200$

⁵ 24 months for biennial valuations.

⁶ Beginning of period for biennial valuations.

⁷ Cal-PERS policy, for public agencies is that contribution rates are effective 2 years after the valuation date. For example, the June 30, 1995 valuation generates contribution rates that are effective July 1, 1997. Sponsors with fiscal years beginning after June 30 may want to discuss with their auditors the materiality of contribution rates becoming effective more than 24 months after the valuation date.

Accounting For Pensions
By State And Local Governmental Employers
Continued

- all economic assumptions should include same inflation assumption.
- The ARC is the sum of normal cost and amortization of unfunded actuarial accrued liability, provided:
 - amortization can be as a level dollar or a level percentage payroll;
 - maximum amortization period - initially 40 years, grading to 30 over next 10 years;
 - minimum amortization period - 10 years - applicable only when liability decreases because actuarial method changes.
- The actuarial asset value should be market related.
- Contribution deficiencies or excess contributions amortized beginning with the next valuation, unless settlement expected within 1 year.
- Actuarial assumptions should be:
 - selected using Actuarial Standard of Practice #4, "Measuring Pension Obligations" - essentially this standard requires assumptions be explicit (each assumption stands by itself);
 - based on covered group's actual experience;
 - consistent with each other.
- One of six actuarial cost methods should be used: (1) entry age, (2) frozen entry age, (3) attained age, (4) frozen attained age, (5) projected unit credit, or (6) aggregate.⁸

Initial NPO Calculation

When Statement 27 is first adopted the initial NPO is calculated, looking back over fiscal years beginning after December 15, 1986.⁹ Most Cal-PERS public agencies initial NPO will be zero, because sponsors have generally contributed based on Cal-PERS calculated contribution rates.¹⁰ However, sponsors should note that contributing other than the Cal-PERS contribution rate may generate a net pension obligation or asset.¹¹

Required Notes To The Financial Statements

The following items are required financial statement note disclosure:

- Plan Description
- Funding Policy:
 - Annual Pension Cost (APC) and \$ amount of contributions made - components of APC (ARC, interest on NPO, adjustment to ARC).

⁸ Cal-PERS uses Entry Age.

⁹ GASB has indicated that initial NPO calculation does not require strict adherence to parameters.

¹⁰ Recently there were 3 instances (1993/94, 1994/95 and 1995/96) where Cal-PERS provided public agencies rate choices (i.e. allowed an agency to select the contribution rate from among alternatives). Conversations with GASB and Cal-PERS indicate that these 3 instances will not result in an NPO. Specifically, GASB said that if contributions made were "actuarially based" then no NPO at transition is generated. Furthermore, we understand Cal-PERS is comfortable saying these contribution choices were each "actuarially based".

¹¹ For example paying off any or all of the unfunded actuarial liability (e.g. via a pension obligation bond) or contributing at a rate that's less (or more) than the rate Cal-PERS provided.

**Accounting For Pensions
By State And Local Governmental Employers
Continued**

- Three years of data:
 - APC
 - % of APC Contributed
 - NPO at end of year
- Actuarial valuation date, actuarial method(s) and significant assumptions used to determine ARC.

Required Supplementary Information (3 Years)

The following items are financial statement required supplementary information:

- Actuarial valuation date, actuarial asset value, actuarial accrued liabilities, total unfunded actuarial liabilities, actuarial assets as % of actuarial accrued liability (funded ratio), annual covered payroll, and ratio of unfunded liability to annual covered payroll.
- Factors significantly affecting trends in the above amounts.

Defined Contribution Plans

Employers with defined contribution plans should recognize annual pension expenditures/expense equal to their required contributions, in accordance with the terms of the plan.

The notes to the financial statements should include the following information:

- Plan name, plan administrator, and identification of the plan as a defined contribution plan;
- Brief description of plan provisions and authority under which they were established and/or may be amended;
- Contribution requirements; and
- Contributions actually made by plan members and sponsor.

Statement 26

Statement 26 is an interim statement establishing financial reporting standards for postemployment healthcare plans administered by state and local governmental defined benefit pension plans.

Disclosure requirements for postemployment benefits, including postemployment healthcare benefits, are included in Statement 12.

Statement 26 applies at the aggregate plan (all employers) level. The aggregate plan or system is not required to present the information required by this statement for the individual plans of the participating employers.

Statement 26 requires:

- A statement of postemployment healthcare plan net assets; and

**Accounting For Pensions
By State And Local Governmental Employers
Continued**

- A statement of changes in postemployment healthcare plan net assets.

Notes To The Financial Statements:

- Plan description;
- Summary of significant accounting policies.
- Contributions.

Supplementary information is not required, but if presented must be in the same format as the pension statements.

Statement 25

Statements 25 and 27 are very similar documents. Both statements focus on enhancing understanding and usefulness of pension information included in the financial reports of state and local employers (pension plans). For agent plans, Statement 25 applies for the aggregate (all employers) plan. Since the California PERS is an agent multiple-employer plan, Statement 27 includes the disclosures that should be made for the individual plans of employers that participate.

Most public agencies participating in PERS will not need to worry about Statement 25, however, some of these agencies may also be administering a defined benefit or defined contribution plan for other, non-PERS employees (e.g. a plan benefiting part-time employees in lieu of providing Social Security coverage). These sponsors must follow the reporting and disclosure requirements of Statement 25.

Statement 25 includes additional information not included in Statement 27:

- Statement of plan net assets;
- Statement of changes in plan net assets;
- Required schedule of funding progress;
- Required schedule of employer contributions;

This information is to be presented immediately following the notes to the financial statements.

Notes To The Financial Statements

- Plan Description:
 - Single, agent multiple, or cost sharing multiple employer.
 - Classes of employees covered.
 - Brief description of benefit provisions.
- Summary of Significant Accounting Policies:
 - Basis of accounting.
 - Brief description of how fair value of investments is determined.
- Contributions and Reserves:
 - Authority under which obligations to contribute are established, or amended.

**Accounting For Pensions
By State And Local Governmental Employers
Continued**

- Funding policy, and how costs to administer are financed.
- Required contribution rates.
- Brief description of terms of long-term contracts for contributions and amounts outstanding at reporting date.
- Balances in plans' legally required reserves at reporting date.
- Concentrations - identification of investments in one organization that equal 5% or more of plan assets.

SAMPLE FOOTNOTE

Sample footnote for employer participation in Agent Multiple Employer Plan (Cal-PERS)

City of _____ Notes to the Financial Statements for the Fiscal Year Ended June 30, 1995.

Note XX: Pension Plan

Plan Description: The City of _____ contributes to the California Public Employees Retirement System (PERS), an agent multiple-employer public employee defined benefit pension plan. PERS provides retirement and disability benefits, annual cost-of-living adjustments, and death benefits to plan members and beneficiaries. PERS acts as a common investment and administrative agent for participating public entities within the State of California. Benefit provisions and all other requirements are established by state statute and city ordinance. Copies of PERS' annual financial report may be obtained from their Executive Office - 400 P Street - Sacramento CA 95814.

Funding Policy: Participants are required to contribute 7% (9% for safety employees) of their annual covered salary. The City makes the contributions required of City employees on their behalf and for their account. The City is required to contribute at an actuarially determined rate; the current rate is 6.966% for non-safety employees, 10.825% for police employees, and 10.849% for fire employees, of annual covered payroll. The contribution requirements of plan members and the City are established and may be amended by PERS.

Annual Pension Cost: For 1995, the City's annual pension cost of \$5,221,174 for PERS was equal to the City's required and actual contributions. The required contribution was determined as part of the June 30, 1994, actuarial valuation using the entry age normal actuarial cost method. The actuarial assumptions included (a) 8.5% investment rate of return (net of administrative expenses), (b) projected annual salary increases that vary by duration of service, and (c) 2% per year cost-of-living adjustments. Both (a) and (b) included an inflation component of 4.5%. The actuarial value of PERS assets was determined using techniques that smooth the effects of short-term volatility in the market value of investments over a four-year period (smoothed market value). PERS unfunded actuarial accrued liability is being amortized as a level percentage of projected payroll on a closed basis. The remaining amortization period at June 30, 1995, was five years for prior service unfunded, and 16 years for remaining unfunded.

Accounting For Pensions
By State And Local Governmental Employers
Continued

THREE-YEAR TREND INFORMATION FOR PERS (\$ Amount in Thousands)

<u>Fiscal Year</u>	<u>Annual Pension Cost (APC)</u>	<u>Percentage of APC Contributed</u>	<u>Net Pension Obligation</u>
6/30/93	\$5,850	100%	\$ 0
6/30/94	5,764	100	0
6/30/95	5,221	100	0

REQUIRED SUPPLEMENTARY INFORMATION (\$ Amount in Thousands)

	(A)	(B)	(C)	(D)	(E)	(F)
Actuarial Valuation Date	Actuarial Asset Value	Entry Age Actuarial Accrued Liability	Unfunded Actuarial Accrued Liability [(B) - (A)]	Funded Ratio [(A) / (B)]	Covered Payroll	Unfunded Actuarial Liability as Percentage of Covered Payroll {[(B)-(A)]/(E)}
6/30/93	\$ 158,718	\$ 156,338	\$ (2,380)	101.5%	\$ 32,979	7.2%
6/30/94	172,994	170,346	(2,648)	101.6	32,428	8.2
6/30/95	Not Available	Not Available	Not Available	Not Available	Not Available	Not Available